

INTERNATIONAL Poverty Centre

Country Study number 12 October, 2007

*The International Poverty Centre is jointly supported by the Brazilian Institute for Applied Economic Research (IPEA)
and the Bureau for Development Policy, United Nations Development Programme, New York.*

Country Study

A PROPOSED STRATEGY FOR GROWTH, EMPLOYMENT AND POVERTY REDUCTION IN UZBEKISTAN

Country Study published by IPC, n° 12

Terry McKinley
Acting Director,
International Poverty Centre

and

John Weeks
Professor Emeritus,
School of Oriental and African Studies,
University of London

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**United Nations Development Programme
International Poverty Centre**

International Poverty Centre
SBS – Ed. BNDES, 10º andar
70076 900 Brasília DF
Brazil

povertycentre@undp-povertycentre.org
www.undp-povertycentre.org
Telephone +55 61 2105 5000
Fax +55 61 2105 5001

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Print ISSN: 1819-897X

COUNTRY STUDY PUBLISHED BY THE INTERNATIONAL POVERTY CENTRE

A PROPOSED STRATEGY FOR GROWTH, EMPLOYMENT AND POVERTY REDUCTION IN UZBEKISTAN*

Terry McKinley** and John Weeks***

This Country Study provides an outline of a Strategy for Growth, Employment and Poverty Reduction in Uzbekistan. It recommends that the country seek to achieve a six per cent trend rate of economic growth based on increases in domestic public and private investment, instead of relying, as it currently does, on external demand for primary commodities. It also recommends measures to increase the employment intensity of growth and reduce inequality so that the country's pattern of growth could become broad-based and inclusive. In order to achieve these goals, the study calls for more expansionary fiscal policies, focused on increasing public investment; moderately more accommodating monetary policies, designed to maintain positive but low real rates of return to stimulate private investment; and a managed exchange rate, targeted to boost the country's international competitiveness and diversify its economy. The study notes that Uzbekistan does not lack savings; what it lacks are the means to mobilize its ample but underutilized private domestic savings. For mobilizing such savings and directing it to productive private investment, the study recommends an industrial policy, which could deploy various measures, such as tax and subsidy instruments, directed commercial credit and public-sector matching funds for private investment. The study recommends that an investment bank, based on joint public-private ownership, should spearhead industrial policy. Directing resources from capital-intensive sectors, formerly favoured by the government's import-substitution policies, to internationally competitive employment-intensive sectors would be part of such an industrial policy, especially in order to enhance productive employment. The study favours supplementing such measures, which promote growth and employment, with more poverty-focused policies and programmes, such as an enlarged, rural-focused public works scheme, doubling public investment in agriculture and providing small farmers with greater access to land, other productive resources and credit.

* The authors gratefully acknowledge the helpful comments and suggestions from the two external peer reviewers of this Country Study: Andrea Giovanni Cornia, Professor of Economics at the University of Florence, and Claudio Dos Santos, Director of the Department of Public Finance in the Institute for Applied Economic Research in Brazil. The authors also wish to thank the international consultants who joined with them in producing the general report on "A Proposed Strategy for Growth, Employment and Poverty Reduction in Uzbekistan: an Input Report into the national Welfare Improvement Strategy". These include Sedat Aybar, Azizur Rahman Khan, Jens Lerche, Sheila Marnie and Valdimir Mikhalev. They also want to thank Galina Saidova, Deputy Minister of the Economy for hosting this initiative and the staff members of the Centre for Economic Research (CER) for the support that they provided to the general report. Particular thanks are due to Bakhodur Eshonov, Uktam Abdurakhmanov, Ildus Kamilov (the main focal point), Ulugbek Olimov and Nuriddin Vaisov of CER. Special thanks are also due to Fikret Acura, the U.N. Resident Coordinator and UNDP Resident Representative, and Kyoko Postill, the UNDP Deputy Resident Representative, for their support of the report.

** Acting Director, International Poverty Centre, Brasília.

*** Professor Emeritus, School of Oriental and African Studies, University of London.

The study also calls for strengthening the country's social policies, education and health in particular, and its system of social protection. For health, it emphasizes strengthening primary health care and, for education, it stresses ensuring a full 12-year cycle of secondary education, including professional and vocational education. It also calls for improving the efficiency and equity of the country's community-based *mahalla* system of social protection, which it believes has functioned fairly well during the transition period.

1 INTRODUCTION

This Country Study summarizes and develops the major findings and policy conclusions of the general report, *A Proposed Strategy for Growth, Employment and Poverty Reduction in Uzbekistan: an Input Report into the Welfare Improvement Strategy* (McKinley 2007). This report was produced in 2007 by a team of international and national consultants supported by the Centre for Economic Research and the UNDP Country Office in Uzbekistan and the International Poverty Centre in Brasilia. The report was presented to the Ministry of Economy of Uzbekistan as an 'input' into the government's formulation of a new Welfare Improvement Strategy.

The Input Report provides recommendations to Uzbek policymakers for a broad-based Welfare Improvement Strategy concentrating on achieving 'Growth, Employment and Poverty Reduction'. The Government of Uzbekistan has planned to utilize its new Welfare Improvement Strategy as the basis for a Poverty Reduction Strategy Paper, to be submitted to the World Bank and the International Monetary Fund.

The Input Report has benefited from the contributions of an earlier UNDP-supported report to the Government of Uzbekistan, "Growth and Poverty Reduction in Uzbekistan in the Next Decade" <<http://www.undp-povertycentre.org>>, published in September 2003 (Cornia 2003). This report was commissioned by the Poverty Group of the Bureau for Development Policy and produced by a team of international and national consultants organized by Terry McKinley and led by Giovanni Andrea Cornia. The Centre for Economic Research and the UNDP Country Office were the national supporters of this report.

This Country Study is organized to address several major interrelated issues for the country's national strategy. The next section, on **Economic Performance**, reviews trends in growth, inequality and poverty since the country's independence. Based on this review, it favours a Welfare Improvement Strategy that targets a realistic and sustainable rate of economic growth based on expanded domestic investment combined with explicit efforts to reduce inequality, which will make the pattern of growth more equitable in its impact.

The third section, on **Macroeconomic Policies**, offers major recommendations on implementing more expansionary fiscal policies, moderately more accommodating monetary policies and active management of the exchange rate in order to foster the country's international competitiveness. These recommendations are meant to support a moderately high rate of economic growth based on both domestic as well as external demand.

The fourth section, on **Structural Policies**, covers two areas: Policies to Promote Investment and Savings, and Growth-Promoting Industrial Policies.

The subsection on **Investment and Savings** recommends a significant increase in Uzbekistan's investment/GDP ratio based on more effective mobilization of the large untapped pool of private saving. It favours a leading role for public investment, particularly in order to stimulate faster growth of private investment. Based on assumptions about feasible

investment ratios and capital-output ratios, the section recommends sustaining a six per cent long-term rate of economic growth. Calculating such a rate does not assume that the current favourable external demand for Uzbekistan's primary commodities will continue indefinitely.

The second part of the fourth section covers **Industrial Policies**, which are integrated with an expansionary macroeconomic framework and include various measures: a 'crowding-in' strategy, channelling resources to priority sectors, a tactical use of tax and subsidies and of commercial credit to promote certain sectors, a use of public-sector matching funds for private-sector investment projects and the design of mechanisms to channel private savings into investment.

The fifth section focuses on generating **Broad-Based Employment**. This involves fostering a more employment-intensive pattern of growth by re-allocating resources away from more capital-intensive sectors of the economy and towards more internationally competitive employment-intensive sectors. This would involve various measures, such as those identified for Industrial Policy, to create a bias in favour of tradable commodities. The section also offers recommendations on supply-side measures to enhance employment and on poverty-focused programmes, such as an enlarged public-works scheme.

The sixth section deals specifically with focusing resources on **Poverty Reduction** in order to ensure that growth and employment generation benefit poor households, particularly in rural areas, where most of the poverty in Uzbekistan is concentrated. The emphasis of the section is on improving the access of poor households to social and economic opportunities, such as health care, education, skill development and productive resources.

As part of the focus on poverty, the seventh section concentrates on the reform of **Agriculture and Land Tenure** relations. The section favours continuing the system of leasehold rights to land. It recommends balancing the state's favourable treatment of private capitalist farmers with more attention to enhancing the economic opportunities of small *dekhan* farmers, such as through providing them with greater access to land, credit and infrastructure. Such measures would not involve a trade-off with growth rural incomes since *dekhan* farming is more productive than either larger capitalist farms or the *shirkats*. The section also favours putting a priority on stimulating employment in rural nonfarm enterprises.

The eighth section, on **Human Development and Social Protection**, provides recommendations on improving health, education and social protection in Uzbekistan as a complement to measures to boost economic growth and broad-based employment. Recommendations include providing a minimum package of health services and a full 12-year cycle of secondary education and improving the efficiency and equity of the *mahalla* system of social assistance.

The Country Study ends with **Concluding Remarks**, which summarize the general strategic directions that it has outlined.

2 ECONOMIC PERFORMANCE, 1991-2006

The 2003 UNDP-supported report (Cornia 2003) noted that, like other transition countries in Europe and Central Asia, Uzbekistan suffered a severe economic decline immediately after independence. For a meaningful comparison of performance across these countries, one must distinguish between the Central European countries and the former Soviet Republics, which include Uzbekistan.

The Central European countries were considerably more developed; indeed, the former German Democratic Republic and what is now the Czech Republic were more industrialized than the Soviet Union at the end of World War II. Several of the Central European countries, especially Hungary, Poland and Romania, had substantial trade with non-socialist countries. This reduced the shock induced by the rapid opening of their economies.

These states had the formal institutions of independent countries—for example, ministries to manage international trade and fiscal policy. By contrast, the former Soviet Republics had little or no trade outside COMECON and had government institutions that were not suited to independent states.

While Uzbekistan's decline was greater than that of the Central European countries, it was significantly less than that of other former Soviet Republics. This is illustrated in Table 1 and Figure 1. During the early 1990s, the decline of the Baltic states averaged almost 12 per cent per annum, and that for the other former Soviet Republics over 15 per cent. If one excludes the petroleum exporters, the decline of the latter group was more than 16 per cent. By comparison, Uzbekistan's economy contracted at less than seven per cent per annum.

After the years immediately following independence, the Baltic states recovered on the basis of capital inflows from Western Europe, but the former Soviet Republics stagnated. During 1995-1999, the growth of Uzbekistan was again above the average for the non-Baltic republics, although low at about one per cent per annum.

TABLE 1

Comparative Economic Performance of Uzbekistan, GDP Growth per annum, 1991 – 2006

Countries	1991-94	1995-99	2000-06	1991-06
Central Europe	-3.3	3.2	4.5	2.1
Baltic states	-11.7	4.8	8.0	2.1
Other Soviet Republics	-15.4	.2	9.2	.3
Other Soviet Republics*	-16.3	.1	8.3	-.4
Uzbekistan	-6.8	1.1	5.1	.9

Notes: Central Europe: Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia.

Baltic states: Estonia, Latvia and Lithuania.

Other Soviet Republics: Fourteen former Soviet Republics in Eastern Europe and Central Asia.

Other Soviet Republics*: The previous category excluding the major petroleum exporters (Russia, Azerbaijan and Kazakhstan).

Source: EBRD 2007.

The 2003 UNDP-supported report on Uzbekistan, mentioned above, attributed the relatively less disastrous performance of the country partly to the government's avoidance of a hasty liberalization of the economy. Specifically, it demonstrated that the import-substitution trade regime prevented the collapse of domestic agriculture and manufacturing, which was a widespread occurrence in other former Soviet Republics (Cornia 2003). Also, there was an exchange-rate regime, which complemented the regulation of trade, which minimized capital flight.

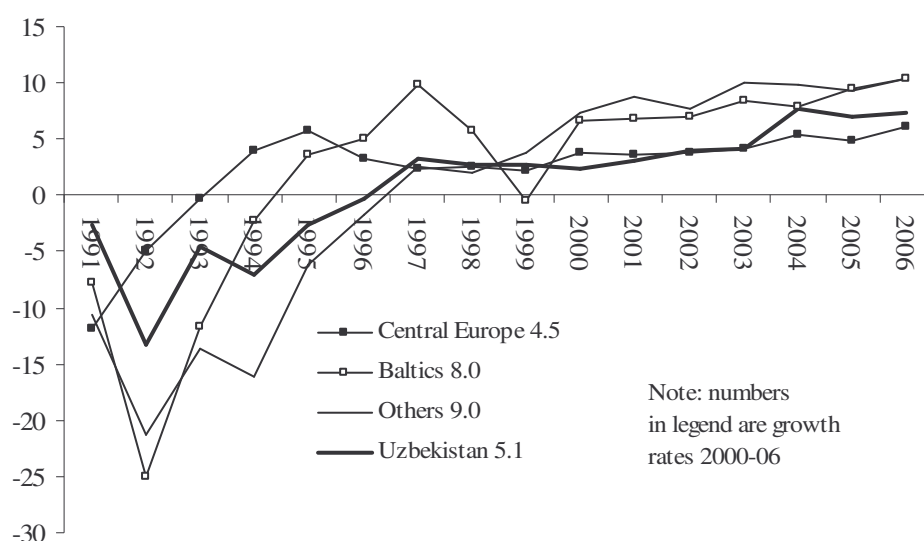
But the 2003 report also stressed that the policies that had sustained the economy during the earlier crisis decade would not be adequate to foster rapid and sustainable growth in the 2000s. Table 1 confirms the validity of this argument. During 2000-2006, growth in Uzbekistan,

while respectable (i.e., about five per cent), was well below the average (8-9 per cent) of the other former Soviet republics, whether or not one includes the petroleum exporters (Table 1).

In summary, the post-independence growth of Uzbekistan was considerably better than that for similar former Soviet Republics. However, in the 2000s its relative performance has declined even as its absolute growth rates have risen. These trends suggest an untapped potential for achieving faster *trend* rates of growth. Also, if more broadly based, such growth could bring dramatic gains in employment and poverty reduction.

FIGURE 1

Comparative Economic Performance of Uzbekistan, GDP Growth, 1991 – 2006



Related to the need to achieve sustainable growth, a long-term challenge for Uzbekistan is to diversify its economy and, in particular, diversity its exports away from a heavy reliance on primary commodities. Exports are dominated by cotton, energy and gold: together they have accounted for almost two thirds of the total. Current rates of growth are based on rising external demand for such commodities.

As an example of the problem, the mining sector, which is important to the Uzbek economy, has negligible linkages with other sectors and generates few jobs. Clearly, such primary commodities are a narrow—and unreliable—base on which to generate a long-term sustainable growth process.

2.1 CURRENT PATTERNS OF GROWTH, INEQUALITY AND POVERTY

To the extent that is feasible, the government of Uzbekistan should strive to stimulate a more broad-based pattern of growth. Not only would such a pattern be more sustainable but also it would help create more employment and be more equitable in its impact.

During 2001-2005, Uzbekistan achieved an average growth rate of 5.7 per cent while, at the same time, the proportion of the population in extreme income poverty decreased slowly, from 27.5 per cent to 25.8 per cent (Table 2). While poverty decreased from 22.5 per cent to 18.3 per cent in urban areas, it remained virtually unchanged in rural areas, at about 30 per cent.

This demonstrates that the benefits of growth were bypassing the rural population. Correcting this problem is critical to Uzbekistan's MDG target of halving extreme income poverty by 2015. Halving poverty would imply reducing the headcount ratio from 27.5 per cent to about 14 per cent.

Since income increased by about 25 per cent during 2001-2005 while extreme income poverty decreased by only eight per cent, the elasticity of poverty with respect to national income was only 0.32. If economic growth were maintained at the same rate of 5.7 per cent over the whole period 2001-2015, halving extreme income poverty could not be achieved without improving the poverty elasticity of growth (namely, without enhancing equity in the pattern of growth). This elasticity would have to be increased by at least 44 per cent, to 0.46, for the MDG target to be achieved.

TABLE 2

Poverty Headcount 2001 – 2005 (Per cent)

	2001	2002	2003	2004	2005
National	27.5	26.5	27.2	26.1	25.8
Urban	22.5	21.8	22.0	18.8	18.3
Rural	30.5	29.4	28.7	30.3	30.0

Source: HBS (see McKinley 2007 for details).

Such an improvement would involve making economic growth much more broad-based and undertaking explicit measures to reduce income inequality. The modest but feasible goal of decreasing the Gini coefficient of income inequality from 0.45, which is recorded in 2005, to 0.40 by 2015—namely, by about 11 per cent—would help Uzbekistan reach the target of halving extreme income poverty. This would signify that poorer households, especially in rural areas, had improved their access to the expanding opportunities to generate income. Improving conditions in rural areas is key not only to lowering inequality but also to reducing poverty.

The reduction of inequality is particularly important for Uzbekistan because its measure of income poverty, which is based on a food poverty line, captures mainly the extremely poor, whose incomes are often not very responsive to economic growth alone. They lack the skills, education, assets and resources to take advantage of economic opportunities. Universalizing the coverage of social policies can solve part of this problem but economic programmes explicitly focused on poverty, such as small-scale public works in rural areas or enlarging the plots of *dekhan* farmers, would have to complement such policies.

The alternative for Uzbekistan is to maintain a much higher average rate of economic growth over the whole period 2001-2015. For example, if the economy were able to maintain an average of a seven per cent rate of growth (such as it has in recent years), income would increase by over 150 per cent. If the elasticity of poverty with respect to national income would remain the same as it is currently, namely, about 0.30, then extreme income poverty would decrease by 50 per cent, as targeted.

But this approach is a strategy entailing significant risks, particularly since the country's current high rate of economic growth is heavily dependent on favourable external conditions, over which the country has virtually no control. Even the assumption of a constant elasticity of 0.30 is likely to be optimistic since as extreme income poverty is reduced, the remaining households that are in deep poverty become increasingly more difficult to reach with just generalized increases in growth.

3 MACROECONOMIC POLICIES

To achieve a more rapid rate of economic growth, at least three major changes are required:

1) Implementing more expansionary macroeconomic policies, 2) achieving a substantially higher investment share in GDP, and 3) using industrial policy to channel resources to the sectors with greatest growth and employment potential. This section deals with the macroeconomic regime while Section IV deals with issues of investment and savings, and industrial policy.

The strong external demand for primary commodities, which has driven Uzbekistan's export performance since 2000, needs to be complemented by an expansionary fiscal policy, which would require, in turn, a more accommodating monetary regime. To be successful, such an orientation would have to be combined with exchange-rate management.

To generate sustained growth of capacity as well as expanding domestic demand, fiscal policy should be driven by public investment. Boosting public investment would contribute to increasing the share of investment in GDP, with the goal of moving it from its current inadequate level of about 20 per cent of GDP to 25 per cent. Such a level could reasonably be expected to sustain a six per cent rate of growth (as we will demonstrate later in this study).

But fiscal policies in Uzbekistan have not been sufficiently expansionary. It is acknowledged that after the large budget deficits of the early and middle 1990s, fiscal adjustment was necessary. As a result, during 2000-2006, the public budget was almost in balance, with a slight positive balance across the seven years (see Table 3). This slight surplus should not, however, be seen as a positive indicator; on the contrary, it is evidence of a serious fiscal constraint on the economy.

TABLE 3

Macroeconomic Indicators for Uzbekistan, 2000 – 2006

Item/year	2000	2001	2002	2003	2004	2005	2006
Per cent change							
GDP Growth	3.8	4.2	4.0	4.2	7.7	7.0	7.2
GDP Deflator	47.3	45.2	45.5	26.8	15.9	16.0	20.3
Per cent of GDP							
Consolidated. Budget Revenues	37.1	34.6	33.3	32.7	30.8	32.0	32.5
Consolidated. Budget Deficit	0.8	0.9	0.8	-0.2	0.4	0.6	-1.5
Gross Savings	19.4	20.0	22.4	26.9	31.9	23.7	33.1
Fixed Capital Expenditure	21.4	24.2	19.4	19.3	20.2	19.8	20.3
External sector							
Exchange Rate, year end, Soum/\$	325	688	970	980	1058	1180	1280
Inflation adjusted*	100	146	141	113	105	101	91
Exports of Goods and Services, mil.\$	3265	3170	2988	3725	4853	5409	6058
Imports of Goods and Services, mil \$	2947	3137	2712	2964	3816	4091	4390

Source: State Statistics Committee.

The nearly balanced budget has run contrary to sound macroeconomic policy for two major reasons. The first relates to what is known as 'fiscal drag', which occurs when a government runs a balanced budget under conditions of excess capacity in the private sector.

Because tax revenues generally rise as output increases, a balanced budget that is accompanied by excess capacity implies that the government is running a *structural* surplus as the economy grows.

However, the surplus also implies that demand, domestic demand in particular, is insufficient to sustain the increased output. If the economy is to reach its full capacity, either taxes must be reduced or public expenditures increased. Fiscal drag characterized the economy of Uzbekistan after 2000. Its rapid growth was achieved despite this problem because of the good fortunes conferred by strong export demand.

The second reason that Uzbekistan has been following unsound macroeconomic policies is that its balanced budget has implied that the government has been funding public investment out of current revenue. The difference between public investment and current expenditure is that the former creates an asset that generates a flow of output over many years. Part of the future output that is generated is received by the government as taxes. If public investments have a positive rate of return, then the taxes that they generate will cover the original capital expenditure used to create the asset.

Therefore, the public sector would have potentially paid for its investments twice, namely, once through current expenditure and twice through the future taxes generated by the public asset. It is for a similar reason that private enterprises fund their investments in new plant and equipment by borrowing on the capital market. The same financing principle should be applied to the public sector.

But financing additional public investment is not likely to be consistent with the current conservative monetary policy of targeting low CPI inflation rates of 3-4 per cent. Such a policy implies maintaining relatively high real rates of interest. Abandoning such a restrictive inflation target would allow real interest rates to be reduced to the level of the so-called 'Golden Rule', which specifies that non-distortionary long-term rates should be equivalent to the sustainable growth rate of per capita income.

The inflation rate, as measured by the GDP deflator, has been more than cut in half since 2002 (Table 3). Despite some increase since 2005, inflation has remained within a moderate range. As long it remains within such a range, it is not likely to have adverse effects on the economy. Cross-country empirical evidence has demonstrated that Inflation rates (as measured by the CPI) of up to 15 per cent are not likely to be detrimental to growth. Greater flexibility on inflation targets would provide the policy space for significantly expanding public and private investment. Such expansion would boost, in turn, the productive capacity of the economy, enabling aggregate supply to respond, in due course, to rising aggregate demand.

Abandoning strict inflation-targeting would also make exchange-rate management feasible. As inflation declined and export growth increased, there was an appreciation of Uzbekistan's currency after 2002. In most countries high nominal and real interest rates exert pressure for currency appreciation by attracting short-term capital inflows. Given the relatively closed capital account of Uzbekistan, this is unlikely to be an important effect of the current interest-rate policy.

Moreover, the measures that the central bank would take to arrest pressure for appreciation, e.g., purchases of foreign exchange, would tend to drive nominal interest rates down as a result of the resulting increase in the domestic money supply. Therefore, a low-inflation policy, because it requires strict limits on the growth of the money supply, would contradict effective exchange-rate management.

Since any increase in the domestic money supply would tend to drive interest rates down, countering the effort to maintain a low-inflation target, abandoning such a target would free the central bank to pursue an integrated monetary and exchange-rate regime that would be more supportive of expansionary fiscal policy and rapid and sustained growth.

Such a package would include: 1) low interest rates to foster private investment; 2) interventions in the currency market to achieve a competitive, export-diversifying exchange rate; and 3) increased liquidity to accommodate fiscal expansion. Since managing the exchange rate is crucial to fostering greater international competitiveness, strict inflation targeting would be inconsistent with such an objective—especially since it would also undermine fiscal expansion.

Hence, the summary of our recommendations for macroeconomic policies is as follows:

1. Expansionary fiscal policy, in which the overall deficit approximates the share of public investment in GDP;
2. More accommodating monetary policy that maintains positive but low long-term real rates of interest; and
3. Currency management through central bank interventions focused on maintaining a competitive exchange rate.

4 STRUCTURAL POLICIES

4.1 POLICIES TO PROMOTE INVESTMENT AND SAVINGS

Economic growth in Uzbekistan accelerated in the mid-2000s to seven per cent per annum and higher, mainly because of more favourable external conditions, including higher prices for its exports of primary commodities and increased inflows of remittances from out-migration of its workforce. As a result, the country's current account surplus reached a very high 20 per cent of GDP in 2006. Also, as already mentioned, the government has run budget surpluses throughout most of the 2000s (Table 3).

As already discussed, a budget surplus or even a small deficit is not currently a rational policy for Uzbekistan, given its need for increased investment, especially public investment, which should be financed from public borrowing. As we see below, the nearly balanced budget plus the large trade surplus have implied that private saving has considerably exceeded private investment (for such an indication, see Table 3). This excess of private saving presents an opportunity to both increase overall investment and enhance the contribution of the private sector to the growth process.

The private-sector saving surplus indicates that the problem of financing growth in Uzbekistan is not due to lack of saving, but to the failure to *mobilize* savings for investment purposes. Saving is more than adequate to boost investment from its current level of about 20 per cent of GDP to the target of 25 per cent. Also, because such an increase would be funded out of available saving, it would not likely be inflationary. But critically lacking are the mechanisms to convert savings into productive investment—a topic that we discuss below. The long-term solution is to restructure and strengthen the country's banking system but in the short- to medium-term, the government will have to play an important role in mobilizing national savings.

The statistics for analyzing investment are presented in Tables 4 and 5, and shown graphically in Figures 2-4. The available sources in Uzbekistan do not report private investment and saving, but these items can be deduced from the national income identity by assuming inventory change to be zero. By definition,

$$[\text{private investment} - \text{private saving}] + [\text{public expenditure} - \text{public revenue}] + [\text{exports} - \text{imports}] + [\text{inventory change}] = 0$$

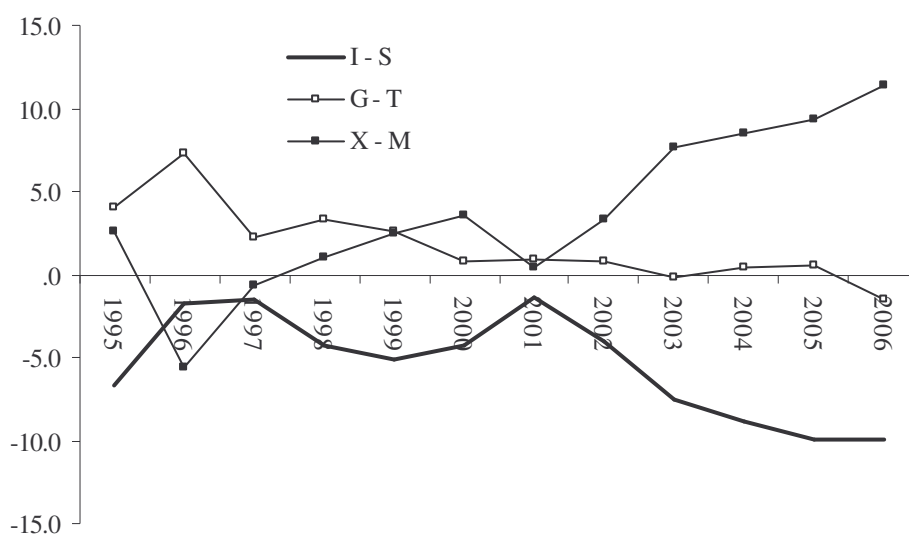
In symbols (assuming inventory change is zero),

$$[I - S] + [G - T] + [X - M] = 0$$

The three 'gaps', the private-sector balance ($I - S$), the public-sector balance ($G - T$), and the external-sector balance on goods and services ($X - M$), are shown in Figure 2. In a market-based economy, inventory change is a small portion of national product, and tends to balance out over time; the logic of such assumption is that inventories cannot decline below zero, and enterprises that continuously accumulate unsold goods will go bankrupt. Therefore, the misestimates resulting from the assumption of zero inventories tend to cancel out one another over time.

FIGURE 2

The Three Macroeconomic 'Gaps', per cent of GDP, 1995 – 2006



Notes: The calculation of ($I-S$) assumes that inventory change is zero.

Sources: EBRD 2006 for 1995-1999, and Ministry of Economy subsequently.

Dividing through by national income gives the share of each variable. The shares of exports, imports, government expenditure and revenue are known. By accounting logic, this condition directly implies the private-sector balance. The total investment share is also known, as are the shares of public and foreign investment. These directly imply the share of private investment by domestic agents and the share of private saving. These shares, actual and calculated, are reported in Table 4.

TABLE 4

Macro Balances, Saving and Investment in Uzbekistan, 1995 – 2005 (Shares of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Macro Balances												
I - S (private)	-6.6	-1.7	-1.6	-4.3	-5.1	-4.3	-1.3	-4.1	-7.5	-8.9	-9.9	-9.9
G - T	4.1	7.3	2.2	3.3	2.6	0.8	0.9	0.8	-0.2	0.4	0.6	-1.5
X - M	2.6	-5.6	-7	1.0	2.5	3.5	.4	3.3	7.7	8.5	9.3	11.4
Saving & investment												
Consump/GDP	40.6	48.1	56.9	50.7	55.1	43.8	44.7	45.0	43.0	42.0	40.3	na
Consump/D income	62.2	73.2	81.3	73.6	77.9	68.8	68.5	69.6	65.2	62.5	60.9	na
Private saving	24.7	17.6	13.1	18.2	15.6	19.8	20.5	19.7	23.0	25.3	25.9	na
Gross investment	24.2	23.0	18.9	20.9	17.1	21.4	24.2	19.4	19.3	20.2	19.8	20.3
Private domestic	18.4	15.2	9.9	12.6	9.0	14.7	18.1	14.8	14.8	14.9	14.5	na
FDI	-.3	.7	1.6	1.3	1.5	.8	1.1	.8	.7	1.5	1.5	na
Public	6.1	7.1	7.4	7.0	6.6	5.9	5.0	3.8	3.8	3.8	3.8	na
Other indicators:												
GDP growth	-.9	1.6	2.5	3.4	3.7	3.7	4.2	4.1	4.1	5.0	5.7	6.5
Marginal K/Y	na	14.4	7.6	6.2	5.5	5.5	5.1	5.1	5.2	4.5	3.7	3.2

Notes: The public sector balance (G - T) and external balance (X - M) are from reported statistics. A positive value for (G - T) is a budget deficit. G includes current and capital expenditure. For the private sector balance (I - S), the official statistics on total investment are accepted. Government 'centralised investments' are from reported data, as is foreign direct investment. Therefore, private domestic investment and private saving (S) are implied on the assumption that inventory change is zero. 'D Income' is disposable income and equal to GDP minus government revenue. Consumption (Consump) is disposable income minus private saving. Note that disposable income includes profits of private enterprises. 'Marginal K/Y' is the ratio of gross investment to the GDP growth rate.

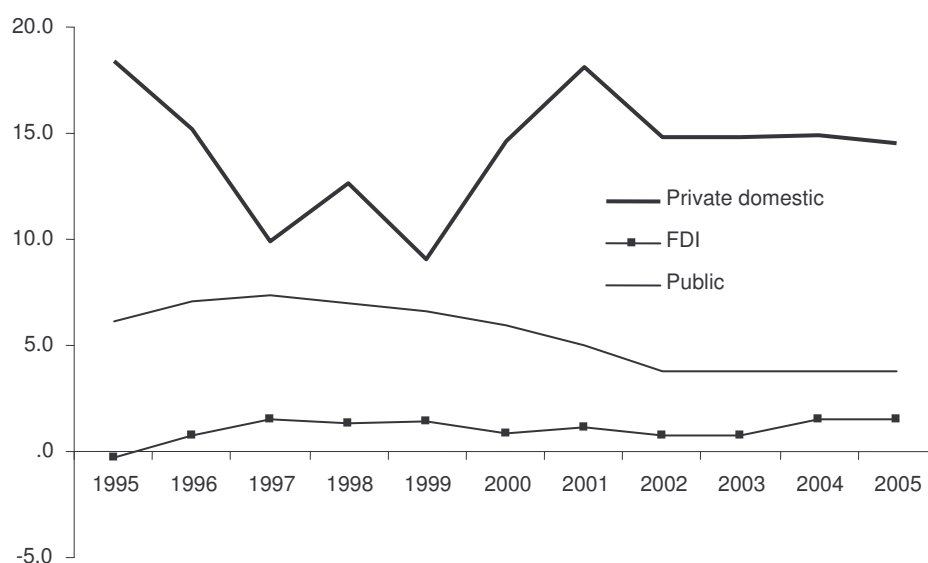
Sources: EBRD2006 for 1995-1999, and Ministry of Economy subsequently.

Figure 3 shows the components of total investment for 1995-2005. Foreign investment was of little importance, accounting for about one per cent of GDP from 1997 onwards. This low level is consistent with cross-country evidence that demonstrates that foreign investment is of minor importance in low-income countries without substantial exploitable natural resources. Because of the limited size of the domestic market of Uzbekistan but, more importantly, the high transport costs that it faces as a landlocked country, there are limited prospects for foreign investment inflows. The exceptions would likely be investments in the gold sector and investments by Russian enterprises in the non-mineral sectors.

Figure 3 shows that public investment has been in continuous decline as a proportion of GDP from 1997 onwards. In 1997, it was 7.4 per cent of GDP but by 2002 it had dropped below five per cent. By 2006-2007 (a period not shown in Figure 3), public investment had declined to under three per cent. Even taking account of investment by the Road Fund would increase this ratio to only four per cent in 2007.

It is vitally important to reverse this decline. Increasing public investment would contribute to the goal of increasing the overall investment ratio by five percentage points. Hence, a major goal of fiscal policies should be to raise the ratio of public investment to GDP from about four per cent back up to six per cent. This would add two percentage points to the target of raising the overall investment ratio by five percentage points. Moreover, if public investment were properly designed, it could help stimulate ('crowd-in') the needed increase in private investment. Such efforts should be consolidated and organized in Uzbekistan through a Public Investment Programme.

FIGURE 3

Components of Investment, 1995 – 2005 (Percentage of GDP)

Sources: EBRD 2006 for 1995-1999, and Ministry of Economy subsequently.

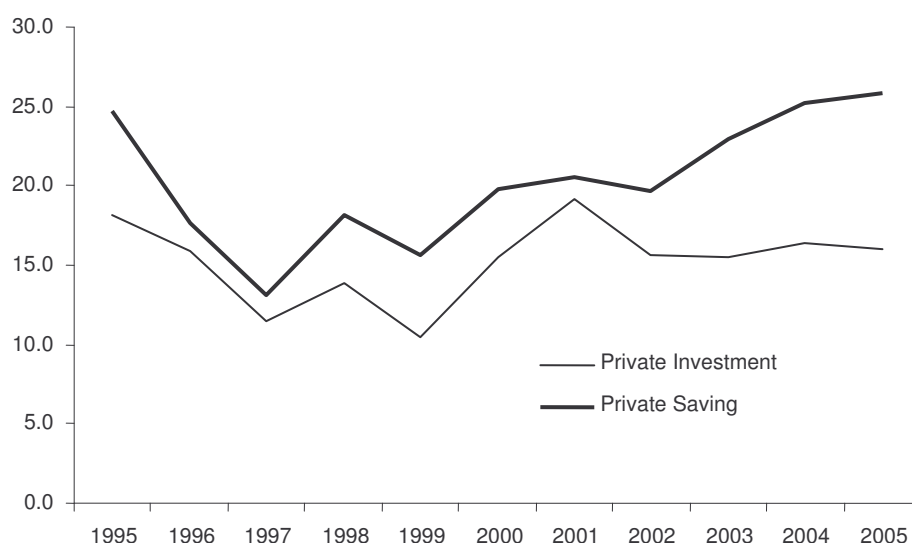
Financing is not lacking. Such an increase in public investment could be financed directly by the 'fiscal space' created by the reduction in Uzbekistan's external debt. As a ratio to GDP, such debt dropped from 42 per cent in 2003 to 23 per cent in 2006. The resources formerly devoted to interest payments could now be allocated to capital expenditures, without the government having to borrow from private savings.

Another promising development with regard to public investment has been the initiation of the Fund for Reconstruction and Development. This Fund has been designed to tap into the large holdings of gross official reserves of the Central Bank. In 2007, these reserves were about US\$ 4.6 billion. The Fund is authorised to use a portion of these foreign-exchange reserves, which have been deposited by the Central Bank in its account, to help finance capital imports for projects in Uzbekistan financed by foreign investors.

The pattern for private domestic investment during 1995-2005 followed the general trends in the economy. During the 1990s, when the economy contracted and then expanded sluggishly, private investment declined (Figure 3). This is what one would expect because the economy was operating with considerable excess capacity and a low level of profitability. As the economy recovered and excess capacity declined, private investment recovered; then in 2001 it rose to slightly above its previous high of 18 per cent of GDP. Subsequently, however, it declined sharply and then stagnated at about 15 per cent of GDP through 2005.

Simultaneously with the stagnation of the share of private domestic investment, the share of private saving rose substantially, from about 20 to over 25 per cent of GDP. This is shown in Figure 4. If private investment had risen along with private saving, as occurred during 1998-2001, the economy would have grown substantially faster on the supply side. Our analysis now considers how much faster the economy could grow, based on this investment-saving disparity.

FIGURE 4

Private Savings and Investment as per cent of GDP (Estimated) 1995 – 2005

Sources: EBRD 2006 for 1995-1999, and Ministry of Economy subsequently.

Table 5 shows calculations of the combination of investment ratios and the capital-output ratios necessary for Uzbekistan to attain various rates of economic growth. The table presents the growth rate of GDP in the first row, and the observed incremental capital-output ratio in the second row. This ratio is the gross ratio because the investment share includes depreciation. Over the ten years of 1997-2006, the incremental capital-output ratio varied from a high of 7.6 in 1997 to a low of 3.2 in 2006. As should be the case, the growth rate and the capital-output ratio are highly negatively correlated. The elasticity between the two is not significantly different from minus one.

This correlation verifies the well-known generalization that capacity utilization varies directly with the growth rate (e.g., as capacity utilization decreases, capital-output ratios rise). However, very high levels of utilization (implying low capital-output ratios) are not sustainable. It is reasonable to conclude that the ratios in 1997 and 1998 are well above the sustainable level, and that the ratio in 2006 is substantially below. Since there is no reliable way to determine the 'optimal' capital-output ratio for Uzbekistan in the 2000s, our growth analysis uses two, the observed ratios in 2004 and 2005 (4.5 and 3.7, respectively). These ratios are used to calculate the investment shares required to sustain growth rates of five, six and seven per cent.

For the upper boundary of the range, i.e., $\Delta K/\Delta Y = 4.5$, the actual investment ratio in 2004 would have been insufficient to achieve any of the three growth rates. For the lower boundary, 3.7, the actual investment rate for 2005 (almost the same as the rate in 2004) would have been more than adequate for a five per cent growth rate, but it would have been too low for six and seven per cent growth rates.

However, if private investment had been equal to total private saving (namely, if it also drew on the extra 'available net saving', i.e., 5.9 per cent, reported in Table 5), a six per cent growth rate could have been achieved. Such calculations illustrate why we believe that roughly a six per cent long-term rate of growth—but not a significantly higher rate—is feasible.

TABLE 5

Estimation of Investment Rates Required for Economic Growth at 5, 6 and 7 per cent

4 year averages	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
GDP growth	2.5	3.4	3.7	3.7	4.2	4.1	4.1	5.0	5.7	6.5
$\Delta K/\Delta Y$	7.6	6.2	5.5	5.5	5.1	5.1	5.2	4.5	3.7	3.2
Implied I/GDP for growth =										
5 per cent								22.3	18.6	
6 per cent								26.7	22.3	
7 per cent								<u>31.2</u>	<u>26.1</u>	
Annual reported I/GDP	18.9	20.9	17.1	21.4	24.2	19.4	19.3	20.2	19.8	20.3
						Investment	5 %	-2.1	1.2	
						Gap:	6 %	-6.5	-2.5	
							7 %	-11.0	-6.3	
						Available	net saving	4.9	5.9	

Notes: To avoid misleading results arising from the negative growth rate in 1995 and the very low rate in 1996, in the first two rows, data begin in 1997, with 1998 being a two-year average, 1999 a three-year average, and all subsequent numbers four-year averages. The capital-output ratio is gross investment over gross national product. The 'implied' I/GDP rows are the actual capital-output ratio times five per cent growth, six per cent growth and seven per cent growth. The 'investment gap' is the difference between the actual investment rate and the implied I/GDP for five, six and seven per cent growth, for the most likely range of $\Delta K/\Delta Y$, namely, 3.7 to 4.5. Available net saving is the difference between private investment and private saving, plus the fiscal surplus

Sources: EBRD 2006 for 1995-1999, and Ministry of Economy subsequently.

The long-term solution to the problem of the lack of mobilization of private savings is the strengthening of domestic financial institutions broadly defined. There will have to be a special focus on strengthening commercial banks in Uzbekistan, which remain weak and underdeveloped. However, because of the current weaknesses in private financial institutions, the public sector will have to take the lead, in the short and medium term, in providing the incentives necessary to transform the current large pool of domestic saving into productive public and private investment.

4.2 GROWTH-PROMOTING INDUSTRIAL POLICY

In Uzbekistan, one of the primary mechanisms for channelling private saving into investment is industrial policy. An essential characteristic of such a policy is that it should be integrated into the overall macroeconomic framework, rather than stand alone. This implies that industrial policy should not be assigned to a line ministry, but be formulated by consultation among the executive branch, the Ministry of Economy and the Central Bank.

A moderately more accommodating monetary policy allows for expansionary fiscal policy to be effective. Through its public investment component, an expansionary fiscal policy creates projects, particularly in infrastructure, which could 'crowd-in' private investment. An exchange rate managed for international competitiveness would complement fiscal policy by helping shift profitability toward public and private investments that diversify the economy. An explicit industrial policy provides a coherent framework for channelling national resources for these purposes.

The possible elements of an industrial policy embedded in an expansionary macroeconomic framework would be the following:

1. **A 'crowding-in' strategy** to induce private investment by lowering transport, utilities, and other operating costs. Although this alone would have a limited impact on aggregate private investment, it is needed as a facilitating policy to make other policy elements more effective.
2. **A sectoral priorities strategy** in which the public sector takes leadership of the future pattern of economic diversification. Such a strategy is more basic than what is often, derisively, called 'picking winners'. By use of the specific instruments described below, the public sector would shift profitability towards sectors of the economy that are relatively employment-generating and have clear export and growth potential.
3. **A tactical use of tax and subsidy instruments** to influence sector-level profitability. These profitability-shifting measures would be tied to export performance and employment generation. For example, the granting of a tax rebate for export performance would be regularly reviewed, and withdrawn if performance did not match the initial conditions on which the rebate was granted. This was the approach used successfully by several East Asian countries, in which public-sector monitoring of outcomes simulated market discipline. Key to the success of this approach is the effective continuous monitoring of outcomes.
4. **A tactical use of commercial credit terms** in order to reduce the investment costs in sectors selected for diversification. Subsidized credit requires coordination with the Central Bank to monitor the overall rate of credit expansion. Responsibility for preventing an excessive expansion of credit lies with this bank. However, if the bank engages, instead, in a non-discriminating policy of credit restriction, this would undermine the use of subsidized credit.
5. **Public-sector matching funds for private-sector investment** projects could provide a powerful incentive for investment. In addition to increasing the funds available for specific projects, it would be a further vehicle for the public sector to assert leadership over investment priorities. (See the earlier discussion of the Fund for Reconstruction and Development, designed for foreign investment.)
6. **Design of mechanisms to channel private saving into investment** in order to raise the aggregate rate of capital formation. Private saving could exceed private investment for several reasons. These could include: near full employment, crowding out due to increases in other aggregate expenditures (exports and government current expenditures); expectations of low profitability by the private sector; and the absence of financial mechanisms to channel saving into investment. The first cause is not relevant for Uzbekistan in the 2000s, and the second was addressed by items 1-4 above. There are several mechanisms for channelling saving into investment that have been successfully used in developing countries, especially in Asia. These are elaborated below.

The six areas outlined above present a menu of options for the government of Uzbekistan. It is not advisable to implement all of them at once. This would make industrial policy unduly complex. The ones considered most critical to achieving success in Uzbekistan's concrete circumstances should be given priority.

4.2.1 An Investment Bank

The basic mechanism for the mobilization of saving in Uzbekistan would be an investment bank. The funding mechanisms for such a bank that would be easiest to design and implement are public-sector schemes that are based on existing programmes. For example, public-employee contributions to pension funds could be deposited into the investment bank, with the government guaranteeing a return above the rate of inflation. Once the security of the scheme was demonstrated, it could be extended to the formal private sector. The most important source of funds for the investment bank would be allocations from a fund created to receive the rents from natural resource booms (with the most important commodity in Uzbekistan being gold).

The government could also institute high marginal income tax rates in order to motivate enterprise owners to retain and invest profits, and apply lower rates if income were deposited in the investment bank. In addition, the investment bank could issue bonds to the public, which would also have a guaranteed rate of return above inflation.

The governance of the investment bank could be designed to ensure credibility for depositors and provide a forum for setting national priorities. The ownership would be by the public sector and the enterprises borrowing from it. This ownership design is based on the model of building societies and savings-and-loan institutions.

In consultation with the government, the board of the investment bank would set the sectoral priorities for loans, which would be linked to the granting of tax concessions and subsidies. The difference between a conventional development bank and such an investment bank would be that the latter would operate on commercial principles, and have private-sector participation in decision-making.

More generally, the long-term solution to the problem of the lack of mobilisation of private savings is the strengthening of domestic financial institutions broadly defined. In the short or medium term, however, the public sector would take the lead via the investment bank and provide the incentives described above in order to transform the current large pool of saving into productive public and private investment.

4.2.2 The Structure of Exports and Imports

Uzbekistan has entered a stage of development in which it has to base its growth on diversification of its exports away from heavy reliance on primary commodities, i.e., cotton, gas and gold. In order to make progress towards this objective, policy makers will have to implement a general industrial policy that would create a bias towards tradable commodities (both exports and import replacements) and a corresponding bias against non-tradables.

Table 6 shows that Uzbekistan has already made some progress in diversifying its exports and decreasing its reliance on the import of food and energy. Between the two periods,

1995-1998 and 2003-2006, the share of exports accounted for by cotton, gold and energy decreased from about three-quarters to less than two-thirds. Cotton exports were cut in half while gold exports, in contrast, increased by over 10 percentage points. But the share of the 'other' category of exports (which includes all exports other than cotton, gold or energy) increased by almost 12 percentage points.

On the import side, the share of food dropped dramatically, namely, from 21.5 per cent to about nine per cent. The share of energy imports also remained low. There was also a positive trend in the rise of machinery imports from about 42 per cent to over 47 per cent. So Uzbekistan has succeeded, in contrast to the experience of many other developing or transition countries, in substantially reducing its dependence on imports of food and energy. At the same time, it has utilized the foreign exchange generated by the export of such primary commodities as cotton, gold and energy to import more capital goods.

The major challenge for Uzbekistan is to build on this success and further diversify its range of exports, particularly by expanding manufacture exports. Industrial policy could be successfully deployed, as discussed above, in order to achieve such objectives.

TABLE 6

Exports and Imports by Broad Category, 1995 – 1998 and 2003 – 2006

	1995	1996	1997	1998	2003	2004	2005	2006	1995-99	2003-06
Exports										
US\$ mns	3475	3535	3695	2888	3240	4262	4757	5842	3398	4525
Percentages										
Cotton	45.6	43.5	37.6	41.5	22.8	20.6	21.7	17.3	42.1	20.6
Gold	17.6	25.6	20.0	9.6	32.3	29.1	27.6	25.2	18.2	28.6
Energy	12.5	7.8	14.3	22.7	14.0	14.1	13.1	13.9	14.3	13.8
Other	24.3	23.0	28.1	26.2	30.9	36.2	37.5	43.7	25.4	37.1
Imports										
US\$ mns	3237	4241	3768	2717	2405	3061	3311	3778	3491	3139
Percentages										
Food	19.1	29.5	20.9	16.4	11.0	7.7	7.8	9.8	21.5	9.1
Energy	1.6	1.1	.6	.6	3.3	2.6	3.1	7.1	1.0	4.1
Machinery	35.6	36.4	49.6	49.8	49.2	51.6	48.1	40.3	42.8	47.3
Other	43.7	33.1	29.0	33.2	36.5	38.1	40.9	42.7	34.7	39.6
Note:										
Net energy exports	10.9	6.8	13.7	22.1	10.7	11.5	10.0	6.8	13.4	9.7

Sources: 1995-1998 from Elborgh-Woytek (2003, p. 8); 2003-2006 from State Statistics Committee of Uzbekistan.

5 GENERATING BROAD-BASED EMPLOYMENT

The success of a Strategy for Growth, Employment and Poverty Reduction in Uzbekistan will be dependent not only on achieving a rapid and sustainable rate of economic growth but also on achieving a more employment-intensive pattern of growth. Currently, the elasticity of employment with respect to growth is low. For example, for every one percentage point change in the economic growth rate, there is, on average, a 0.3-0.4 percentage point increase in formal-sector employment.

This measure of elasticity should be increased to at least 0.5.* This would indicate that growth is being translating into much healthier increases in formal-sector employment, thereby pulling sizeable numbers of workers out of low-income informal-sector activities—and out of farming, in particular—into productive jobs at decent wages. Along with more rapid growth, such an employment trend would also have a powerful impact on reducing poverty. Such an increase in employment intensity would also have a pronounced impact on reducing inequality, which has been on the rise in Uzbekistan.

Achieving such an outcome will involve a redirection of the additional resources generated by growth 1) away from the more capital-intensive sectors of the economy, such as fuel and energy supplies, transport and communication, and ferrous and non-ferrous metals, which have been the foundation of the country's previous State-Led Import-Substitution Strategy and 2) towards the more internationally competitive employment-intensive sub-sectors that can be identified within such industries as chemicals and petrochemicals, light industry and the food industry.

Maintaining a stable and slightly undervalued exchange rate will help to promote this transition to more employment-intensive growth by changing the composition of exports from primary commodities towards industrial products and services. The policy recommendations given earlier, in the section on Macroeconomic Policies, on how to counter the recent appreciation of the exchange rate are highly relevant in this regard.

Gradually removing remaining privileges, inherited from the Import-Substitution Strategy, for capital-intensive industries would help to 'level the playing field' in Uzbekistan relative to previous trends. Such a more neutral set of incentives would tend to foster greater employment intensity because of the previous bias in favour of capital intensity.

A major contribution to employment could result from the implementation of a general industrial policy that creates a bias in favour of tradable commodities, both for the development of new domestic products that are currently imported and new export commodities that would allow the country to diversify its trade. In the previous section, Section V, we have outlined some recommendations on the general direction of such an industrial policy.

Employment could be boosted from the supply side by achieving the government's current objective of providing universal secondary education, including vocational school, for a full 12-year cycle. This would help enhance the country's comparative advantage in medium-skilled labour and contribute to diversifying the country's trade structure. Also, industrial policy could improve supply-side conditions through other similar policies, such as encouraging closer links between enterprises and public educational institutions in order to provide relevant vocational training and to support product research.

It is also necessary to give employment policies a major poverty focus. This objective could be served by complementing pro-poor public transfers, such as social assistance provided by *mahallas*, with small-scale employment-intensive public works programmes. The modest financing now provided for the Employment Fund could be increased in order to expand such public works. While 0.1 per cent of GDP is currently devoted to the Employment Fund, it would be worthwhile to boost this share to 0.5 per cent.

* The employment elasticity of growth should range between 0.5 and 1.0 since values in this range indicate that productivity as well as employment is being created. Values over 1.0 indicate that jobs with low levels of productivity are being generated.

The public-works schemes that are thereby financed could not only provide temporary employment and but also help create durable public infrastructure, such as water canals, dams and rural access roads. The focus should be on rural areas, where poverty is concentrated and where there is a large surplus of labour, especially in the wake of the restructuring of large cooperatives, i.e., the *shirkats*. Such an initiative could also help stem the migration of rural workers out of the country in search of low-skilled employment in neighbouring countries.

In order to lay the foundation for a sustainable increase in remunerative employment, policy makers should avoid the mistake of favouring micro and small enterprises over medium and large enterprises. Such an approach, though seemingly employment-focused, is unlikely to be successful. Creating more formal-sector private employment is the long-run solution to underemployment and poverty in Uzbekistan. And such employment is provided mostly by medium-sized and large enterprises.

It is often a mistake to think that micro and small enterprises could make a major contribution to employment generation because they are supposedly more 'employment intensive'. In fact, employment intensity depends more on the sector than the size of an enterprise. Moreover, larger enterprises are more likely to be able to pay 'poverty-reducing', instead of 'poverty-reproducing', wages.

Economic growth that is more rapid and broad-based will create the increased demand for labour that will drive up real wages. Increasing the productivity of labour—such as through vocational training and skills development—would also intensify labour demand. This pressure would help raise the level of real wages throughout the economy.

Higher real wages cannot be engineered by public policies. The one major exception is the setting of reasonable minimum wage levels, which can have a marked impact on reducing both poverty and inequality.

6 FOCUSING RESOURCES ON POVERTY REDUCTION

While economic growth could be accelerated and employment could become more broad-based, such improvements would not necessarily imply that poor workers, and their families, could access such new economic opportunities. They would need the requisite education, skills and resources to take advantage of such opportunities. But they are poor precisely because, in part, they lack such advantages. Directly confronting such challenges has often been the focus of the national poverty reduction strategies that have been formulated and implemented in many low-income countries in the last two decades.

Instituting such poverty-focused programmes could contribute to making the pattern of economic growth in Uzbekistan more equitable. But success would depend on providing poor households with greater access to land, credit and foreign exchange. It would also depend on strengthening and improving redistributive public transfers, such as the *mahalla* system, and poverty-focused employment programmes, such as public works schemes financed by the Employment Fund.

Increasing pro-poor expenditures on health care, such as for Primary Health Care (particularly in rural areas), should be a major focus of poverty-focused social policies in Uzbekistan. More strenuous efforts against major health problems, such as tuberculosis, hepatitis and HIV/AIDS, would also likely have a strong pro-poor impact.

Any major impact on poverty depends ultimately on substantially expanding efforts in rural areas, starting with increased investment in agriculture. An estimated 70 per cent of the poor are concentrated in rural areas. Hence, this Country Study favours a doubling of the share of total public investment allocated to agriculture, from its current low level of about five per cent to 10 per cent. Such investment is badly needed in rural infrastructure, such as rural roads, irrigation, and land and water reclamation.

In this regard, it might be feasible to utilize the new Fund for Reconstruction and Development to finance some of this proposed investment. Alternatively, an investment bank could make lending to agriculture a major priority; or the existing network of agricultural banks could be provided with greater capitalization in order to effectively address this challenge.

In the following section, Section VII, we examine policies that could have one of the most powerful impacts on poverty, namely, those related to reforming agricultural production and land tenure relationships.

7 REFORMING AGRICULTURAL PRODUCTION AND ENTITLEMENTS TO LAND

Promoting agricultural prosperity and increases in rural incomes in general is obviously critical to making Uzbekistan's growth and development more pro-poor. The poverty incidence in rural areas, i.e., 30 per cent, is much higher than in urban areas, i.e., 18 per cent (Table 2 on Page 6).

The country has abandoned cooperative forms of agricultural production, i.e., the *shirkats*, in favour of a system of private capitalist farming, in which about 200,000 households occupy about 75 per cent of all sown land (Table 7). All other rural households have use-rights only to small plots of land, too meagre to provide any real relief from poverty. Such conditions help explain why recent rapid rates of growth in Uzbekistan have not been benefiting the rural poor.

TABLE 7

Distribution of Sown Land among Different Forms of Organization (Per cent of total)

Year	<i>Kolkhozy/ Shirkats</i>	<i>Sovkhozy</i>	Private Commercial	Individual (Dehkan)	Others
1990	34.9	58.7	-	0.1	6.3
1994	75.3	1.0	-	2.1	21.6
2003	47.5	-	35.6	10.4	6.5
2004	41.0	-	47.7	11.3	-
2006	12.8	-	74.5	12.0	0.7

Note: The source of the data is the State Committee on Statistics. The change of the nomenclature from *kolkhozy* to *shirkats* took place gradually during the mid to late 1990s.

Since the consolidation of this system of capitalist farming is almost complete, the main strategic task of the Welfare Improvement Strategy (which, we believe, has become a 'second-best' option) is to free the capitalist farms from arbitrary constraints and ensure that small *dekhan* farmers are afforded, where feasible, greater access to land and productive inputs.

At this juncture, greater access of thousands of small *dekhan* farmers to land—which would be essential to guarantee food security—has to be achieved mainly as a result of

securing land from failed capitalist farms and the restructuring of the remaining *shirkats*. Currently, *dekhan* farms occupy only 12 per cent of total sown land (Table 7).

The state should also intervene to ensure that small farmers are granted greater access to credit and extension services since such public services are characterized by significant externalities. The Government should also ensure the provision of public infrastructure, such as for transport, irrigation, energy and communication. Financing for such infrastructure should be a major component of the country's Public Investment Programme.

Providing *dekhan* farmers with greater access to land and other productive resources would have a more equitable impact on the distribution of rural incomes. But such measures would not necessarily lead to a significant trade-off with economic growth. Table 8 shows that when ratios of crop value to land are compared, *dekhan* farms are 3-4 times more productive than either private capitalist farms or *shirkats*. Table 9 shows that the cultivation of wheat on private capitalist farms is 10 per cent more productive than on *shirkats*. However, such cultivation is 35 percent more productive on *dekhan* farms than on private capitalist farms.

Various measures could be undertaken to make private farms more productive. This would help raise the general level of rural incomes. Freeing sizeable capitalist farms from bureaucratic constraints could be initiated by the abolition of the system of compulsory procurement and correspondingly allowing such farms access to competitive output and input markets. Moreover, entry into and exit out of farming could be facilitated. A competitive banking system in rural areas could most effectively service the needs of medium and large farmers whereas a system of micro-finance institutions should be expanded to respond to the credit needs of small *dekhan* farmers.

In order to ensure a more effective and equitable system of taxation in rural areas, the government should strengthen the existing system of land taxes, particularly in order to appropriate economic rents from large farms, and institute water charges that more accurately reflect economic costs and thus minimize its wasteful use.

This Country Study endorses continuing the current system of leasehold rights, instead of instituting private property rights, to land. However, if private ownership of land were allowed, then the owners of capitalist farms should be required to pay the full market price of the land to which they have gained legal title.

The Government of Uzbekistan could have achieved more progress against rural poverty had it implemented an egalitarian system of small-scale farming by enlarging the existing *dekhan* plots of land. Instead, its choice of a system of sizeable private capitalist farms explains why there has been only modest reduction in extreme rural poverty despite an acceleration of economic growth in Uzbekistan.

Such a system of capitalist farms also does not provide as much employment per unit of land as a more egalitarian system of peasant farms. This implies that job creation for the large pool of surplus rural labour will have to be galvanized by increased growth in rural and urban non-agricultural activities.

Restructuring of the *shirkats* has precipitated a significant out-migration of rural workers from Uzbekistan, who have found low-skilled, insecure jobs in countries such as Russia and Kazakhstan (Cornia 2006). Thus, it is particularly important to try to stimulate the growth of a rural nonfarm sector, such as the Township and Village Enterprises in China, which could

productively absorb these workers. The pervasive underemployment in rural areas also puts a premium on boosting the employment intensity of industrial and service activities in the rest of the economy, in order to help absorb such a labour surplus.

TABLE 8

Relative Productivity Levels in Different Kinds of Farms (Per cent of total)

	(a) Value of crop			(b) Land			The ratio (a)/(b)		
	2000	2005	2006	2000	2005	2006	2000	2005	2006
Dehkan	43	33	32	12	12	12	3.6	2.8	2.7
Private	9	44	59	16	59	75	0.6	0.7	0.8
Shirkat	48	23	9	72	29	13	0.7	0.8	0.7

Source: Ministry of Agriculture and Water Resource (MAWR).

TABLE 9

Index of Yield per Hectare of Wheat in Private and Dehkan Farms (Shirkats = 100)

Year	Dehkan farms	Private farms
2002	116	96
2003	133	95
2004	143	100
2005	134	99
2006	145	110

Source: Unpublished official data.

8 PROMOTING HUMAN DEVELOPMENT AND SOCIAL PROTECTION

Uzbekistan has had a strong record of implementing effective social policies during the transition period. For the Welfare Improvement Strategy, the priority should be to build on this strong foundation in order to improve the equity, quality and sustainability of such policies.

8.1 EDUCATION AND HEALTH

For education, the key strategic priority should be to achieve universal coverage, free of charge, for a full 12-year cycle of primary and secondary education. This goal, which the government has fully embraced, goes well beyond the Millennium Development Goal for education. As part of this initiative, the government could seek to make a new system of universal professional and vocational education fully accessible.

Since enrolment and completion rates at secondary level are already high, the focus should be on enhancing the *quality* of teaching and student performance. And for promoting equity and reducing poverty, emphasis should be given to improving performance in rural areas.

Additional priorities for the educational policies of the Welfare Improvement Strategy could be: 1) to improve the access of low-income students, especially women, to higher education and 2) to boost pre-school enrolment rates (reasonable goals being by 45 per cent in urban areas and by 20 per cent in rural areas).

In health, the priority of the Welfare Improvement Strategy should be to develop a free minimum package of basic services, targeted in particular to the most vulnerable groups of the

population. The specific goal should be to strengthen the Primary Health Care system. As part of this effort, Rural Doctor's Posts would need to be made the lynchpin of primary health care in rural areas. A major challenge for primary health care is to improve the quality of services, more so than merely broadening access to services.

A special focus of the Welfare Improvement Strategy should be on child health—further reducing, in particular, infant and child mortality by preventing and mitigating the most common childhood disorders and diseases. According to official statistics, both infant and child mortality rates have been in decline since the early 1990s (Table 10).

The improvement of maternal health should also be an integral component of this effort. As part of its commitment to the MDGs, the government is seeking to reduce the child mortality rate by two thirds (which is in line with the global MDG target) and reduce the maternal mortality rate by one third by 2015. Both of these targets are achievable provided that current trends are maintained. In order to do so, efforts will, in fact, have to be intensified since attaining such targets for mortality rates will become increasingly difficult as more progress is achieved.

TABLE 10

Infant and Child Mortality Rates 1991 – 2004**(Official administrative data: number of deaths per 1,000 live births)**

	1991	1993	1995	1997	1999	2002	2003	2004
Infant mortality rate	35.3	32.0	26.0	22.8	20.2	18.4	16.7	15.2
Child mortality rate	48.0	48.6	42.5	37.8	32.5	26.4	22.2	20.6

Source: UNDP 2006, NHDR, based on statistics from the State Statistical Committee.

Uzbekistan should also heighten the priority of confronting the alarming spread of various diseases, such as HIV/AIDS, tuberculosis and viral hepatitis. For HIV/AIDS, the government is committed to instituting preventive measures for groups at risk, providing better access to medical care for those infected and creating a more supportive environment for people living with HIV/AIDS. Similar government efforts will also be mounted in order to stem the spread of TB and hepatitis and to care for those afflicted by these diseases. The government expects to halt the spread of tuberculosis by 2010. It also expects to dramatically slow down the spread of HIV/AIDS by 2010 and to halt its spread by 2015.

In order to reach such targets, public expenditures on health will need to be increased by 1.0-1.5 per cent of GDP. The government could help ensure free access to primary and emergency care for all citizens by reorienting its funding from specialized services to preventive and primary outpatient care and making more efficient use of public financing.

8.2 SOCIAL PROTECTION

The government is committed to improving its widespread system of social assistance. While about 40 per cent of all households receive some form of social assistance (e.g., child benefits, maternity benefits and payments to low-income households), the size of transfers is too small to significantly reduce poverty. Moreover, many people who work in the informal sector do not have access to such social assistance.

The government has already committed itself to augmenting by 50 per cent the amount of funds allocated to targeted social assistance and to improve the efficiency and equity of the community-based *mahalla* system that provides such assistance. While this system has been criticized by some analysts for ineffective targeting of its assistance, its decentralized structure and targeting criteria, based on local knowledge, are commendable features.

Table 11 shows that child benefits and payments to low-income households are fairly well targeted. Almost two thirds of their benefits are directed to the poorest 40 per cent of households. In comparison, a little over half of maternity benefits are allocated to the poorest 40 per cent of households.

TABLE 11

Distribution of Forms of Social Assistance by Quintile

	1 st quintile	2 nd quintile	3 rd quintile	4 th quintile	5 th quintile
Child benefits	36.4	27.9	19.1	12.0	4.6
Assistance to households	39.1	26.1	18.8	9.4	6.6
Maternity benefits	30.9	22.2	21.1	16.7	9.1

Source: Data from Household Budget Survey. Note: the first quintile is the poorest.

The chief problems hampering the *mahalla* system relate to capacity development, the provision of resources adequate for administration of the system at the local level and the consolidation of the various benefits into a more manageable unified system. Moreover, targeting of resources could be improved by transferring more resources from richer *mahallas* to poorer *mahallas*. This would depend on developing a systematic national poverty map in order to more sharply distinguish poorer regions of the country from richer ones.

With regard to social insurance, the government should concentrate on making its system more sustainable. The largest group of beneficiaries from the system are old-age pensioners. But many of the workers in the informal sector are not part of this system. The government is working to guarantee a minimum pension for all while supplementing such basic provision with additional benefits tied to contributions made by, or on behalf of, individuals.

Unemployment benefits are so meagre (about 10 per cent of the average wage) that only a small fraction of the unemployed seeks to obtain them. A strategic priority is to build up the Employment Fund (by increasing its funding from 0.1 per cent to 0.5 per cent of GDP) in order to finance temporary employment on public works schemes. Such funding could also be used to provide micro-credit for the unemployed so that they could start micro-enterprises.

In the short term, the government will need to improve the targeting of its social protection system and enlarge the size of the benefits that it provides; but in the longer term, the expansion of employment opportunities in the formal sector and sustainable increase in the earnings of workers are the only strategically viable solutions.

9 CONCLUDING REMARKS

This Country Study has laid out the outlines of a Strategy for Growth, Employment and Poverty Reduction in Uzbekistan. It emphasizes the importance of a relatively high and sustainable rate of economic growth, namely, six per cent, if Uzbekistan is to succeed in halving extreme income poverty by 2015.

But it maintains that the pattern of this growth should be broad-based, resulting from a greater employment intensity of growth and reductions in inequality. Uzbekistan has recently achieved relatively high rates of growth, but these have been reliant on rising external demand for primary commodities and have had not had a broad-based impact on human welfare.

This study recommends that if Uzbekistan is going to sustain a long-term six per cent rate of economic growth, the motive force for economic expansion should become domestic public and private investment. The overall investment/GDP ratio should rise from about 20 per cent to 25 per cent. Otherwise, given prevailing capital-output ratios, long-term rates of growth are likely to be lower than six per cent and, consequently, Uzbekistan would not be able to halve extreme income poverty by 2015.

This study recommends more expansionary macroeconomic policies, supportive of accelerations in investment and greater diversification of exports. It calls for expansionary fiscal policies, which are focussed on financing increased public investment. It also recommends moderately more accommodating monetary policies that can maintain positive but low long-term real rates of interest. Such rates can stimulate private investment. And it calls for management of the exchange rate through central bank interventions in the currency market focused on achieving international competitiveness. Success in such management can support diversification of the country's exports beyond primary commodities.

This study notes that the problem of financing growth in Uzbekistan is not attributable to a lack of domestic savings but to an inability to mobilize the large pool of savings that is available. In recent years, private savings have been significantly increasing while private investment has languished. Public investment can play a crucial role in closing this investment-saving gap by stimulating ('crowding in') private investment.

But what is needed strategically is a general industrial policy that could help boost private investment through various channels. This would include directing public resources or motivating private resources to flow into priority sectors for growth, export diversification and employment. Various measures could be utilized for this purpose, such as tax and subsidy instruments, directed commercial credit and public-sector matching funds for private investment. This study recommends that an investment bank should be formed in order to spearhead this effort of mobilizing domestic savings and channelling it into productive private investment.

The Country Study emphasizes that the success of Uzbekistan's development strategy depends not only on achieving a rapid rate of economic growth but also a more employment-intensive pattern of growth. Improving employment intensity will depend on channelling resources, such as through an industrial policy, away from the more capital-intensive sectors, which were previously favoured under the country's import-substitution industrialization strategy, to the more internationally competitive employment-intensive sectors. This will involve creating a bias in favour of tradable commodities, both exports and import replacements.

This study also calls for supporting supply-side policies, such as ensuring universal 12-year secondary education, which would boost the skills of the labour force, and implementing a public-works scheme through the Employment Fund that could provide temporary employment and build infrastructure, particularly in rural areas.

The public-works initiative is part of the set of recommendations made by the Country Study to focus resources explicitly on poverty reduction. This is based on the assumption that even if growth is rapid and employment-intensive, there is no guarantee that poor workers will be able to take advantage of the new economic opportunities that are created. The reason is that they lack the education, skills and resources to do so.

In order to strengthen the poverty impact of the country's Welfare Improvement Strategy, the Country Study calls for doubling public investment in agriculture. It also calls for continuing the system of leasehold rights to land but focusing on providing small *dekhan* farmers with greater access to land as well as to infrastructure, credit and extension services. Such initiatives are important because extreme income poverty remains concentrated in rural areas and has not been responsive to recent increases in export-led economic growth. An integral part of such initiatives would be a focus on stimulating rural nonfarm employment, which could help absorb the large labour surplus in rural areas.

The Country Study ends with a series of recommendations on social policies and social protection. These include endorsement of the government's current effort to ensure a full 12-year cycle of secondary education, including professional and vocational education, and an emphasis on providing a free minimum package of basic health services. This study focuses on the need to ensure attainment of the MDG targets on reducing child and maternal mortality and halting the spread of tuberculosis and HIV/AIDS.

Finally, this study notes that Uzbekistan has maintained a relatively widespread system of social assistance, built on the community-based *mahalla* system. While acknowledging the success of such a system, the study calls for improving the efficiency and equity of the *mahalla* system, through greater efforts at capacity development, the provision of resources for improved administration and the consolidation of its various benefits into a more manageable unified system.

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International Poverty Centre

SBS – Ed. BNDES, 10º andar
70076 900 Brasília DF
Brazil

povertycentre@undp-povertycentre.org
www.undp-povertycentre.org
Telephone +55 61 2105 5000
Fax +55 61 2105 5001